Magnus Enterprises

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Ms. Mary Rupp
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Dear Ms. Rupp:

I would like to thank the NCUA for the opportunity to comment on the current state and the future shape of the corporate credit union network. I believe that the NCUA, under Chairman Fryzel's leadership, has initiated very good policies that have reduced the probability of the corporates' unrealized investment losses turning into a anchor that would sink the corporates and many natural person credit unions (NPCU's).

I trust the NCUA when they say that every comment letter received will get an honest reading, and I thank you in advance for considering my ideas despite my anonymity.

Background

I applaud the NCUA board for seeking an "in-house" solution to the problems plaguing the corporate credit union network. The credit union industry is both well-capitalized and blessed with leaders who want to leave an industry stronger than the one they inherited. Moreover, I believe that a self-funded "bailout" that doesn't rely on taxpayers' funds will resonate with members and potential members who are suffering from bailout fatigue. Any in-house solution will be an expensive one. As we now know in the wake of the recent conservatorship actions, the eventual realized losses in the corporates' investment portfolios will greatly exceed their total capital and expose the NCUSIF to losses.

The NCUA has adopted the proper strategy in attempting to hold these securities within the corporate network until they mature. A forced sale in the current environment would be catastrophic to the corporates' capital and to the NCUSIF. Natural person credit unions should support the NCUA's plan by providing liquidity to the corporates, either through the CU SIP program or by making fully-insured deposits into their corporate.

My proposed solution is for the NCUA to condense the corporate network to a single corporate credit union. This proposal pares the most cost from the system and provides the best returns on the natural person credit unions' deposits and capital. The new corporate credit union (hereafter called NewCorp) must consent to unprecedented levels of transparency including disclosure of executive compensation and details on travel and entertainment expense.

A more problematic issue will become what to do with the existing corporates. The overriding objectives should be to transfer as much of the existing capital as possible into NewCorp, to generate as much buy-in as possible from the existing stakeholders, namely the NPCU's, and to avoid any transaction that forces the unrealized investment losses to be realized. One possible outcome is to leave the existing corporates in place, but to strip them of NPCU depository authority and as much capital as possible. The illiquid assets will then be funded with deposits from NewCorp into the existing corporates. Allowing NewCorp direct access to the Central Liquidity Facility will also improve the probability of the illiquid securities being held to maturity.

The Role of Corporates in the Credit Union System.

The basic principal that should drive the restructuring of the corporate network is to provide the minimal set of required services at the lowest possible cost. The ANPR asks for comment on certain specific issues, and then I'll offer general opinions on what exactly this list of required services looks like and how structures can be put in place to maximize return to NPCU's.

Payment Systems and Liquidity and Liquidity Management.

Despite the fact that an increasing number of NPCU's are clearing transactions directly through the Federal Reserve and are relying on the Federal Home Loan Bank system for liquidity, there clearly remains a role for payment systems and liquidity services in the corporate network.

Certain NPCU's may lack the manpower and expertise to set up the necessary relationships that would enable clearing or borrowing outside of the corporate network. NewCorp must continue to offer these services.

A recurring theme of this response will be the need to keep as much of the inter-institutional "profit" as possible within the credit union industry. There is clearly money to be made on lending funds to financial institutions. Despite their investment losses, the FHLB system earns substantial operating profits. To cede this revenue to an external institution would shrink the size of the pie for our industry. NewCorp must be allowed to offer liquidity services to NPCU's.

Field of Membership and Structure (two-tiered system)

The NCUA perfectly described the genesis of the current situation in its ANPR document: the combination of nationwide fields of membership and expanded investment authority had the unintended consequence of the large corporates assuming too much risk in their investment portfolios in an effort to pay the best rates on deposits (or at least keep up with their competitors).

Even leaving the corporate network unchanged, this problem would largely go away on its own. Now that everyone better understands the true risks of privately-issued mortgage securities, both the NCUA's examiners and the portfolio managers and boards of directors at the corporates will inevitably "self-regulate" these types of investments off the books.

But this doesn't mean that the current structure is the right structure. Clearly the two-tiered structure of retail and wholesale corporates is too expensive and has a lot of redundant costs. The solution is to eliminate one of the two layers.

In a perfect world, we could let the invisible hand of the free market guide us. If the retail corporates could engage in unfettered competition, NPCU's would move their funds to where service was the best, returns the highest, and costs the lowest. The retail corporates could merge when it made sense, thereby reducing redundant costs. The problems with this proposal include the unintended consequences of competition (e.g. the excessive risk taking in investments that we see today) and the fact that the current management of the retail corporates has shown little appetite for reducing costs following mergers.

So what if we imposed geographic field of membership constraints to mitigate some of the competitive pressure? We would end up with a number of retail corporates that offered nearly identical services and had to carry similar overhead structures. The corporates would naturally impose checks on each other (e.g. it would be difficult for a corporate to underpay its members on certificates if it was clear what the other corporates were paying.) The drawback to this approach is that it's not the lowest-cost solution. With several corporates doing substantially the same thing, the NPCU's aren't getting the most bang for their buck.

The best solution is to restructure the corporate network as a single corporate credit union (NewCorp). This is the solution that extracts the most redundancies and costs from the system and results in the greatest return to members. The lack of competition may be a concern, since there's no guarantee that the single corporate isn't underpaying depositors on shares and certificates. But since the customers are also the owners, any underpayment on deposits should translate to higher earnings, which should get passed through as higher dividends on capital. Additionally, NewCorp still must compete with other financial institutions like banks and the FHLB system. It will not be able to be off-market on its rates and survive. In order to make the chartering of NewCorp more acceptable to NPCU stakeholders, I would recommend that the NCUA bar senior management from any conserved corporate credit union from employment at NewCorp.

The major drawback to relying on a single corporate credit union would be if the management of NewCorp decided to pay themselves too much or spend too lavishly on travel or entertainment expenses. These concerns can be addressed with transparency. NewCorp should be required to disclose the salary and benefit details of all its employees at the VP-level or above (or perhaps of the top 25 highest paid employees). It should have annual meetings at its offices, or if it meetings need to be rotated geographically, they should be held at easy-to-get-to locations and at mid-priced hotels. No events at four-star resorts should be scheduled. NewCorp should be required to share detailed information with members regarding operating expenses.

Expanded Investment Authority

The corporate credit unions have maintained that investing in the types of securities they selected in recent years was necessary to provide members with certificate rates that were competitive with agency bullets and callables. I don't dispute this.

But what if a lot of the cost of the corporate network was eliminated through consolidation? And what if a lot of the credit analyst and risk management positions could be eliminated if the portfolio got a lot simpler? What if NewCorp only offered term CD's and not structured products like callable certificates?

More importantly, what if the need to beat agency yields was removed? If there aren't corporates competing against one another for deposits, then the arms race towards higher yields goes away. And if we view corporate certificates not as a core investment but simply as a service provided to credit unions who don't want to deal with the safekeeping, investment accounting or marking-to-market of securities (or who are too small to efficiently buy securities), then corporate CD's simply need to match agency yields. Under these conditions, a portfolio invested in agency mortgage securities can yield enough to pay competitive rates on term certificates.

Expanded investment authority needs to be eliminated, and NewCorp should only be able to invest in the permissible investments as dictated to federal credit unions in the FCU Act and in Part 703 of the NCUA Rules and Regulations, with one exception. NewCorp should be allowed to purchase asset-backed securities that it issues that are securitized exclusively with NPCU-originated loans.

One additional systemic benefit of reduced investment authority would be a large reduction in headcount and expense at the NCUA. If the Office of Corporate Credit Unions only had to examine one institution, and if that institution had a relatively simple investment portfolio, the OCCU suddenly could become a one-person department.

Required Services from the New Corporate Entity

Here is the complete list of what NPCU's need from their corporate: payment systems, liquidity, overnight investments, term investments (corporate certificates), brokerage service, and investment safekeeping. It should be possible to provide all these at NewCorp, reducing cost to NPCU's and ensuring the best possible risk-adjusted return on deposits and capital.

- Payments, Liquidity and Overnights: These will basically be unchanged from the current system. Consolidation will reduce the systemwide costs. One new liquidity service should be a securitization division that can package credit union-originated loans into asset-backed securities. These securities should be made permissible investments for both NPCU's and NewCorp. Think of this as loan participations, but on a grander scale.

- Term Investments: NewCorp will only offer term certificates; no structured CD's will be issued. NewCorp will primarily invest in agency mortgage securities, but will be permitted to buy the ABS of credit union-originated loans. Credit risk will be greatly reduced.

- Securities Brokerage: Many NPCU's will find NewCorp's CD offerings to be suboptimal, and will choose to invest in securities instead. We need to make sure that we capture as much of the brokerage fee as possible within the network. In exchange for doing business with the NewCorp's broker-dealer, NPCU's will get complete transparency on the fees and commissions they pay on their trades. The sales force at the broker-dealer should be salaried employees, so there is no incentive to overcharge NPCU's on their trades.

- Investment Safekeeping: The current corporate network predominantly safekeeps investments through U.S. Central, who relies on JPMorgan Chase for safekeeping. It should be possible to provide in-house safekeeping and direct links between the new corporate and the necessary clearinghouses to avoid sending NPCU funds outside the system.

Corporate Capital

The issue of Tier 1 and Tier 2 capital and Basel II, etc. becomes a lot less relevant with a single corporate credit union. Yes, NewCorp will still have to borrow money and potentially tap debt capital markets, but the higher-quality assets at the new corporate will mitigate much of the concern over capitalization levels.

One thing NewCorp can do to improve its credit ratings would be to favor permanent paid-in capital (PIC) over membership capital shares (MCS). I believe there is a role for MCS as an overflow account that can easily grow or shrink as an NPCU's relationship with its corporate changes through time. But NPCU's currently have 6 dollars of MCS at the retail corporates for every one dollar of PIC. This ratio needs to be closer to 2 dollars of PIC for every dollar of MCS, and NewCorp will undoubtedly benefit from having this extra permanent capital.

Permissible Investments

The only investment with meaningful credit risk that the new corporate entity should be allowed to invest in are asset-backed securities composed entirely of credit union-originated loans. Expected credit losses on these investments can be offset in the underwriting process, when NewCorp should profit by buying loans at less than par.

No future investments in privately-issued mortgage securities should be permitted.

The vast majority of NPCU's neither want nor need credit risk in their investment portfolio, so NewCorp corporate should assume as little credit risk as practical.

Credit Risk Management

The need for credit risk management largely goes away with a more restricted investment portfolio. There will still be some need for in-house credit expertise to evaluate the existing securities and to advise on the securitization of NPCU-originated loans.

The stress testing of the existing investments clearly needs to consider more possible scenarios, and I think the entire risk management industry has learned this lesson from the current environment.

Asset Liability Management

With the changes to permissible investments and the simplification of deposit offerings, ALM at the new corporate will become every bit as straightforward as it is at NPCU's. The current rules in Part 704.8 that call for a base case NEV Ratio of 3 percent and a 2 percent NEV ratio in the stressed scenarios would be too permissive for the conservative rules that govern NewCorp. These figures should be increased to 4 percent and 3 percent respectively. The regulation that allows for a 15 percent decline in NEV under the stressed scenarios can be left unchanged.

Corporate Governance

I advocate a 12-member board of directors for NewCorp, divided into 3 classes of directors. Each member would serve a 3-year term, and 4 seats are up for election each year. Each class of 4 directors should come from 4 different sized credit unions, with the size classifications based on an interval that captures about a quarter of total NPCU assets. For example, roughly 25 percent of the total NPCU assets are in credit unions over $2 billion in assets. Those NPCU's between $700 million and $2 billion have another quarter of total assets. The next quarter includes NPCU's with assets from $190 million to $700 million, and those NPCU's under $190 million in assets comprise another quarter of total assets. Each of these divisions shall elect one new director each year.

I support director compensation at NewCorp. The amount should be relatively minimal, perhaps $5,000 or $10,000 a year, but for this the director is expected to devote an average of roughly 4 hours a week to corporate business. This is very close to token compensation (i.e. no candidate will run purely for the money, and many board members may decide to donate their compensation to a charitable cause), but the fact that each director is getting paid may prompt others in the industry to hold those directors accountable for their decisions.

The supervisory committee and external members of the asset-liability committee should also be offered compensation and should come from NPCU's of various sizes as with the Board of Directors.

Conclusion

The objective with any corporate restructuring should be to create a system that provides the basic required services to NPCU's at the lowest possible cost. A single corporate credit union, properly regulated and with unprecedented transparency, will minimize costs and satisfy members that the new corporate is acting as a prudent steward of their money.

The new corporate entity should see its investment authority reduced, its ALM requirements strengthened, and its access to the CLF guaranteed by statute. With these provisions in place, the existing illiquid, underwater securities on the books of the current corporates can be held to maturity, minimizing the ultimate realized loss to the industry.

Again, thank you the opportunity to comment. Feel free to contact me at unrealizedlosses@gmail.com if I can be of assistance.

Regards,

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